

**DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 97-0448
WITHHOLDING TAX
For The Tax Periods: 1989 through 1993**

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ISSUES

I. Withholding Tax –Dividends

Authority: IC 6-3-4-13, IC 6-3-2-2.8, 45 IAC 1.1-1-9, I.R.C. § 1363, I.R.C. § 1368, I.R.C § 316.

The Taxpayer protests the Department's assessment of withholding tax on distributions made to non-resident shareholders.

STATEMENT OF FACTS

Taxpayer incorporated out-of-state but maintains an Indiana commercial domicile and has elected to be taxed as an S Corporation. Taxpayer's primary source of revenue came from the flow through of income from its various partnership interests.

Taxpayer was audited for the periods of 1989 through 1993. During 1989 through 1992, Taxpayer was owned by six individual shareholders that were non-residents. In 1993, Taxpayer was owned by fifteen shareholders composed of family and trusts of the original six shareholders.

Taxpayer held a limited and general partnership interest in Company A. During the audit period Company A operated numerous Indiana nursing homes and later added three out-of-state locations. Company A was organized out-of-state and has its commercial domicile in Indiana. The bulk of Taxpayer's revenue came from the flow through of income from Company A. Taxpayer also owned a majority interest in Company A.

Taxpayer also held a general partnership interest in Company B which operated a pharmacy in Indiana. Company B was organized out-of-state and has Indiana domicile. Taxpayer owned an 85% interest in Company B.

Finally, Taxpayer held a limited partnership interest in Company C beginning in 1992. Company C was a partnership of investors. Company C's primary investment was a limited partnership interest in Company A and Company B and was organized out-of-state and held an Indiana domicile.

Taxpayer had no property, payroll or sales and operated merely as a conduit between its shareholders and the partnerships it owned. More facts supplied as necessary.

I. Withholding Tax: Dividends

In 1989 and 1990, Taxpayer sustained large losses that were filtered down from the operations of Company A. Although there were losses being shown, Taxpayer paid distributions to its shareholders. The auditor determined these distributions were subject to tax since Taxpayer had a negative capital account and the distributions were made in excess of basis. Taxpayer argues that these distributions represent a return of capital in excess of basis, thus, are not subject to tax.

IC 6-3-4-13 (a) states: “[e]very corporation which is exempt from tax under IC 6-3 pursuant to IC 6-3-2-2.8(2) shall, at the time that it pays or credits amounts to any of its nonresident shareholders as dividends or as their share of the corporation’s undistributed taxable income, withhold the amount prescribed by the department.” An S-Corporation as described by I.R.C. § 1363 is an exempt organization for adjusted gross income tax purposes. IC 6-3-2-2.8(2).

I.R.C. § 1368 states in part:

- (a) GENERAL RULE.-A distribution of property made by an S corporation with respect to its stock to which (but for this subsection) section 301(c) would apply shall be treated in the manner provided in subsection (b) or (c), whichever applies.
- (b) S CORPORATION HAVING NO EARNINGS AND PROFITS.-In the case of a distribution described in subsection (a) by an S corporation which has no accumulated earnings and profits-
 - (1) AMOUNT APPLIED AGAINST BASIS. – The distribution shall not be included in gross income to the extent that it does not exceed the adjusted basis of the stock.
 - (2) AMOUNT IN EXCESS OF BASIS.- If the amount of the distribution exceeds the adjusted basis of the stock, such excess shall be treated as gain from the sale or exchange of property.
- (c) S CORPORATION HAVING EARNINGS AND PROFITS. – In the case of a distribution described in subsection (a) by an S corporation which has accumulated earnings and profits.-
 - (1) ACCUMULATED ADJUSTMENTS ACCOUNT.- That portion of the distribution which does not exceed the accumulated adjustments account shall be treated in the manner provided by subsection (b).
 - (2) DIVIDEND.-That portion of the distribution which remains after the application of paragraph (a) shall be treated as a dividend to the extent it does not exceed the accumulated earnings and profits of the S Corporation.

- (3) TREATMENT OF REMAINDER.- Any portion of the distribution remaining after the application of paragraph (2) of this subsection shall be treated in the manner provided by subsection (b).

Except to the extent provided in regulations, if the distributions during the taxable year exceed the amount in the accumulated adjustments account at the close of the taxable year, for purposes of this subsection, the balance of such account shall be allocated among such distributions in proportion to their respective sizes...

Here, the auditor states that the distributions did exceed the basis of stock. Taxpayer concurs. However, Taxpayer contends that IC 6-3-4-13(a) does not require withholding where the distributions represent a return of capital in excess of basis. They argue that IC 6-3-4-13(a) only requires withholding where the distribution represents a dividend or undistributed taxable income.

I.R.C § 316 defines a dividend as follows:

- (a) GENERAL RULE.- For purposes of this subtitle, the term “dividend” means any distribution of property made by a corporation to its shareholders’
- (1) out of its earnings and profits accumulated after February 28, 1913, or
 - (2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made....

Also, 45 IAC 1.1-1-9 defines a dividend as “a distribution payable by a corporation out of its earnings, profits, or some other source not impairing capital.”

Taxpayer sustained losses and had a negative capital account. Consequently, pursuant to I.R.C. § 1368(b)(2) the distributions should be characterized as the gain from the sale or exchange of property and are not subject to Indiana’s withholding tax.

FINDING

The Taxpayer’s protest is sustained.